Federal Reserve System Audits

Audits of the Federal Reserve System

The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review. The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General. The Office of Inspector General also audits and investigates the Board's programs and operations, as well as those Board functions delegated to the Reserve Banks.

The financial statements of the Reserve Banks are also audited annually by an independent outside auditor. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter "Federal Reserve Banks," the Board's examination includes a wide range of ongoing oversight activities conducted on and off site by staff of the Board's Division of Reserve Bank Operations and Payment Systems.

Federal Reserve operations are also subject to review by the Government Accountability Office. ■

Board of Governors Financial Statements

The financial statements of the Board for 2004 and 2003 were audited by KPMG LLP, independent auditors.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

To the Board of Governors of the Federal Reserve System:

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2004 and 2003, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board at December 31, 2004 and 2003, and the results of its operations, and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we have also issued our reports dated April 1, 2005, on our consideration of the Board's internal control over financial reporting and its compliance with certain provisions of laws, regulations, and contracts. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit conducted in accordance with *Government Auditing Standards,* and should be read in conjunction with this report in considering the results of our audit.

KPMG LLP

April 1, 2005

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	As of December 31, 2004	As of December 31, 2003
ASSETS		
CURRENT ASSETS		
Cash	$ 60,107,292	$ 56,179,654
Accounts receivable	1,696,480	1,251,117
Prepaid expenses and other assets	4,015,067	2,614,354
Total current assets	65,818,839	60,045,125
NONCURRENT ASSETS		
Property and equipment, net (Note 2)	149,028,686	149,595,059
Collections (Note 1)		
Total noncurrent assets	149,028,686	149,595,059
Total assets	$214,847,525	$209,640,184
LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 13,891,861	$ 15,347,390
Accrued payroll and related taxes	4,552,039	5,056,647
Accrued annual leave	14,195,910	13,428,993
Capital lease payable (current portion)	250,794	206,590
Unearned revenues and other liabilities	467,664	390,698
Total current liabilities	33,358,268	34,430,318
LONG-TERM LIABILITIES		
Capital lease payable (non-current portion)	675,271	763,699
Accumulated retirement benefit obligation (Note 3)	594,169	595,601
Accumulated postretirement benefit obligation (Note 4)	5,789,566	5,322,053
Accumulated postemployment benefit obligation (Note 5)	5,308,565	4,949,892
Total long-term liabilities	12,367,571	11,631,245
Total liabilities	45,725,839	46,061,563
CUMULATIVE RESULTS OF OPERATIONS		
Working capital	32,711,365	25,821,397
Unfunded long-term liabilities	(11,692,300)	(10,867,546)
Net investment in property and equipment	148,102,621	148,624,770
Total cumulative results of operations	169,121,686	163,578,621
Total liabilities and cumulative results of operations	$214,847,525	$209,640,184

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES AND CHANGES IN CUMULATIVE RESULTS OF OPERATIONS

	For the years ended December 31,	
	2004	2003
Board Operating Revenues		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$272,331,500	$297,020,200
Other revenues (Note 6)	8,336,581	8,835,440
Total operating revenues	280,668,081	305,855,640
Board Operating Expenses		
Salaries	166,797,724	156,547,392
Retirement and insurance contributions	30,850,441	28,263,776
Contractual services and professional fees	24,835,904	17,501,035
Depreciation and net losses on disposals	12,445,708	12,194,612
Utilities	8,273,801	7,664,716
Travel	7,088,444	5,981,254
Software	6,302,695	5,910,128
Postage and supplies	6,116,355	8,175,120
Repairs and maintenance	3,954,263	4,029,441
Printing and binding	1,944,552	1,864,006
Other expenses (Note 6)	6,515,129	6,642,118
Total operating expenses	275,125,016	254,773,598
Results of Operations	5,543,065	51,082,042
Issuance and Redemption of Federal Reserve Notes		
Assessments levied on Federal Reserve Banks for currency costs	503,784,304	508,144,248
Expenses for currency printing, issuance, retirement, and shipping	503,784,304	508,144,248
Currency Assessments over (under) Expenses	0	0
Total Results of Operations	5,543,065	51,082,042
Cumulative Results of Operations, Beginning of year	163,578,621	112,496,579
Cumulative Results of Operations, End of year	$169,121,686	$163,578,621

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
RESULTS OF OPERATIONS	$ 5,543,065	$51,082,042
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	12,445,708	12,194,612
Increase in assets:		
Accounts receivable, prepaid expenses, and other assets	(1,846,076)	(2,192,814)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	(1,455,529)	3,897,291
Accrued payroll and related taxes	(504,608)	(3,046,063)
Accrued annual leave	766,917	1,555,466
Unearned revenues and other liabilities	76,966	(51,368)
Accumulated retirement benefit obligation	(1,432)	(18,507)
Accumulated postretirement benefit obligation	467,513	404,266
Accumulated postemployment benefit obligation	358,673	650,640
Net cash provided by operating activities	15,851,197	64,475,565
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals	4,005	15,790
Capital expenditures	(11,715,861)	(16,809,964)
Net cash used in investing activities	(11,711,856)	(16,794,174)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital lease payments	(211,703)	(136,901)
Net cash used in financing activities	(211,703)	(136,901)
NET INCREASE IN CASH	3,927,638	47,544,490
CASH BALANCE, Beginning of year	56,179,654	8,635,164
CASH BALANCE, End of year	$60,107,292	$ 56,179,654
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Capital lease obligations incurred	$ 190,538	$ 1,024,491

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED
DECEMBER 31, 2004 AND 2003

(1) Significant Accounting Policies

Organization—The Federal Reserve System was established by Congress in 1913 and consists of the Board of Governors (Board), the Federal Open Market Committee, the twelve regional Federal Reserve Banks, the Federal Advisory Council, and the private commercial banks that are members of the System. The Board, unlike the Reserve Banks, was established as a federal government agency and is supported by Washington staff numbering approximately 1,800, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System.

The Board is required by the Federal Reserve Act to report its operations to the Speaker of the House of Representatives. The Act also requires the Board, each year, to order a financial audit of each Federal Reserve Bank and to publish each week a statement of the financial condition of each such Reserve Bank and a consolidated statement for all of the Reserve Banks. Accordingly, the Board believes that the best financial disclosure consistent with law is achieved by issuing separate financial statements for the Board and for the Reserve Banks. Therefore, the accompanying financial statements include only the operations and activities of the Board. Combined financial statements for the Federal Reserve Banks are included in the Board's annual report to the Speaker of the House of Representatives.

Basis of Accounting—The financial statements have been prepared on the accrual basis of accounting.

Revenues—Assessments for operating expenses and additions to property are based on expected cash needs. Amounts over or under assessed due to differences between actual and expected cash needs flow in to or out of ''Cumulative Results of Operations'' during the year.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for currency printing, issuance, retirement, and shipping of Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

Property and Equipment—The Board's property, buildings, and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

Collections—The Board has collections of works of art, historical treasures, and similar assets. These collections are maintained and held for public exhibition in furtherance of public service. Proceeds from any sales of collections are used to acquire other items for collections. As permitted by FAS 116, the cost of collections purchased by the Board is charged to expense in the year purchased and donated collection items are not recorded. The value of the Board's collections has not been determined.

Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications—Certain 2003 amounts have been reclassified to conform with the 2004 presentation.

(2) Property and Equipment

The following is a summary of the components of the Board's property and equipment, at cost, net of accumulated depreciation.

	As of December 31,	
	2004	2003
Land	$ 18,640,314	$ 18,640,314
Buildings and improvements	132,891,551	129,161,957
Furniture and equipment	44,450,522	43,890,215
Software	12,207,125	11,425,411
Construction in process	4,380,259	0
	212,569,771	203,117,897
Less accumulated depreciation	(63,541,085)	(53,522,838)
Property and equipment, net	$149,028,686	$149,595,059

Furniture and equipment includes $1,230,000 and $1,156,000 for capitalized leases as of December 31, 2004 and 2003, respectively. Accumulated depreciation includes $356,000 and $195,000 for capitalized leases as of December 31, 2004 and 2003, respectively. The Board paid interest related to these capital leases in the amount of $104,000 and $76,000 for 2004 and 2003, respectively.

The future minimum lease payments required under the capital leases and the present value of the net minimum lease payments as of December 31, 2004, are as follows:

	Year ending December 31	Amount
	2005	$ 427,659
	2006	416,274
	2007	416,274
	2008	138,279
Total minimum lease payments		1,398,486
Less: Amount representing maintenance included in total amounts above		(301,512)
Net minimum lease payments		1,096,974
Less: Amount representing interest		(170,909)
Present value of net minimum lease payments		926,065
Less: Current maturities of capital lease obligations		(250,794)
Long-term capital lease obligations		$ 675,271

Construction in process includes costs incurred in 2004 for two long-term security projects. The first, the Electronic Security System, has an estimated cost of $5.1 million and expected completion in 2005. The second, the Security Perimeter Barrier Project, has an estimated cost of $11.8 million and expected completion in 2006.

(3) Retirement Benefits

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multi-employer plan which covers employees of the Federal Reserve Banks, the Board, and the Plan Administrative Office.

Employees of the Board who became employed prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who became employed after 1983 are covered by a non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers at amounts prescribed by the System Plan's administrator. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2004 and 2003, and the Board was not assessed a contribution for these years. Excess Plan assets are expected to continue to fund future years' contributions. Because the plan is part of a multi-employer plan, information as to vested and nonvested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). The Board matches employee contributions to these plans. These defined benefit plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled $330,000 and $312,000 in 2004 and 2003, respectively. The Board has no liability for future payments to retirees under these programs, and it is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basic contribution and were $8,314,000 and $7,692,000 in 2004 and 2003, respectively.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b) and 415(e) of the Internal Revenue Code of 1986. Pension costs attributed to the System Plan reduce the pension costs of the BEP. Activity for the BEP for 2004 and 2003 is summarized in the following table:

	2004	2003
Change in projected benefit obligation		
Benefit obligation at beginning of year	$ 74,956	$ 12,866
Service cost	23,239	13,689
Interest cost	6,170	3,412
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	36,588	44,989
Benefits paid	0	0
Benefit obligation at end of year	$ 140,953	$ 74,956
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	0	0
Plan participants' contributions	0	0
Benefits paid	0	0
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$ (140,953)	$ (74,956)
Unrecognized net actuarial (gain)/loss	(177,773)	(231,189)
Unrecognized prior service cost	(817,732)	(934,339)
Unrecognized net transition obligation	542,289	644,883
Retirement benefit liability	$ (594,169)	$ (595,601)

	2004	2003
Information for pension plans with an accumulated benefit obligation in excess of plan asset:		
Projected benefit obligation	$ 140,953	$ 74,956
Accumulated benefit obligation	33	28
Weighted-average assumptions used to determine benefit obligation as of December 31		
Discount rate	5.75%	6.25%
Rate of compensation increase	4.25%	4.00%
Components of net periodic benefit cost		
Service cost—benefits earned during the period	$ 23,239	$ 13,689
Interest cost on projected benefit obligation	6,170	3,412
Expected return on plan assets	0	0
Amortization of prior service cost	(116,607)	(116,607)
Amortization of (gains)/losses	(16,828)	(21,595)
Amortization of initial (asset)/obligation	102,594	102,594
Net periodic benefit cost (credit)	$ (1,432)	$ (18,507)
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31		
Discount rate	6.25%	6.75%
Rate of compensation increase	4.00%	4.25%

(4) Postretirement Benefits

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2004 and 2003 is summarized in the following table:

	2004	2003
Change in benefit obligation		
Benefit obligation at beginning of year	$ 7,166,146	$ 6,134,395
Service cost	203,229	170,636
Interest cost	443,043	414,319
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	845,851	673,998
Benefits paid	(253,717)	(227,202)
Benefit obligation at end of year	$ 8,404,552	$ 7,166,146

	2004	2003
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contribution	253,717	227,202
Plan participants' contributions	0	0
Benefits paid	(253,717)	(227,202)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$(8,404,551)	$(7,166,146)
Unrecognized net actuarial (gain)/loss	2,537,211	1,760,246
Unrecognized prior service cost	77,774	83,847
Prepaid/(accrued) postretirement benefit liability	$(5,789,566)	$(5,322,053)
Components of net periodic cost for year		
Service cost	$ 203,229	$ 170,636
Interest cost	443,043	414,319
Amortization of prior service cost	6,073	6,073
Amortization of (gains)/losses	68,885	40,440
Total net periodic cost	$ 721,230	$ 631,468

The liability and costs for the postretirement benefit plan were determined using discount rates of 5.75 percent and 6.25 percent as of December 31, 2004 and 2003, respectively. Unrecognized losses of $2,537,211 and $1,760,246 as of December 31, 2004 and 2003, respectively, result from changes in the discount rate used to measure the liabilities. Under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the Board may have to record some of these unrecognized losses in operations in future years. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 4.25 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored life insurance programs. The Board has no liability for future payments to employees who continue coverage under the federally sponsored life and health programs upon retiring. Contributions for active employees participating in federally sponsored health programs totaled $8,223,000 and $7,188,000 in 2004 and 2003, respectively.

(5) Postemployment Benefit Plan

The Board provides certain postemployment benefits to eligible former or inactive employees and their dependents during the period subsequent to employment but prior to retirement. Costs were projected using the same discount rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Board for the years ended December 31, 2004 and 2003, were $733,000 and $957,000, respectively.

(6) Other Revenues and Other Expenses

The following are summaries of the components of Other Revenues and Other Expenses.

	As of December 31,	
	2004	2003
Other revenues		
Data processing revenue	$3,984,610	$4,639,084
Rent	2,332,089	2,029,514
Subscription revenue	787,053	799,356
Reimbursable services to other agencies	673,730	588,894
National Information Center	15,422	24,422
Board sponsored conferences	0	275,110
Miscellaneous	543,677	479,060
Total other revenues	$8,336,581	$8,835,440
Other expenses		
Tuition, registration, and membership fees	$2,048,610	$1,615,074
Contingency operations	782,052	704,699
Public transportation subsidy	800,724	732,124
Subsidies and contributions	635,336	627,854
Administrative law judges	492,155	307,173
Meals and representation	377,963	534,618
Equipment and facilities rental	307,999	439,751
Security investigations	286,711	473,659
Former employee related payments	205,627	507,082
Miscellaneous	577,952	700,084
Total other expenses	$6,515,129	$6,642,118

(7) Commitments

The Board has entered into several operating leases to secure office, training and warehouse space for remaining periods ranging from one to four years. In addition, the Board has entered into an agreement with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, through the Federal Financial Institutions Examination Council (the "Council") to fund a portion of enhancements for a central data repository project through 2013.

Mimimum annual payments under the operating leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2004, are as follows:

2005	$163,363
2006	71,991
After 2006	0
	$235,354

Rental expenses under the operating leases were $156,000 in 2004 and 2003.

(8) Federal Financial Institutions Examination Council

The Board is one of the five member agencies of the Council, and currently performs certain management functions for the Council. The five agencies which are represented on the Council are the Board, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision. The Board's financial statements do not include financial data for the Council. Activity related to the Board and Council for 2004 and 2003 is summarized in the following table:

	2004	2003
Board paid to the Council:		
Assessments for operating expenses of the Council	$ 112,020	$ 105,920
Central Data Repository	326,640	630,000
Uniform Bank Performance Report	199,230	201,666
Total Board paid to the Council	$ 637,890	$ 937,586
Council paid to the Board:		
Data processing related services	3,360,055	3,485,701
Administrative services	133,500	72,250
Total Council paid to the Board	$3,493,555	$3,557,951

(9) Federal Reserve Banks

The Board performs certain functions for the Reserve Banks in conjunction with its responsibilities for the Federal Reserve System, and the Federal Reserve Banks provide certain administrative functions for the Board. Activity related to the Board and Reserve Banks for 2004 and 2003 is summarized in the following table:

	2004	2003
Board paid to the Reserve Banks:		
Assessments for employee benefits	$ 2,151,078	$ 2,137,781
Data processing and communication	1,920,996	1,963,247
Contingency site	1,481,452	704,699
Total Board paid to the Reserve Banks	$ 5,553,526	$ 4,805,727
Reserve Banks paid to the Board:		
Assessments for currency costs	$503,784,304	$508,144,248
Assessments for operating expenses of the Board	272,331,500	297,020,200
Data processing	686,312	1,484,015
Total Reserve Banks paid to the Board	$776,802,116	$806,648,463

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Internal Control over Financial Reporting

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2004 and 2003, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated April 1, 2005. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

In planning and performing our fiscal year 2004 audit, we considered the Board's internal control over financial reporting by obtaining an understanding of the Board's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards*. The objective of our audit was not to provide assurance on the Board's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. Material weaknesses are conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. However, we noted no matters involving the internal control and its operation that we consider to be material weaknesses as defined above.

We noted other matters involving internal control and its operation that we have reported to the management of the Board in a separate letter dated April 1, 2005.

This report is intended solely for the information and use of the members of the Board and its management, the Office of the Inspector General, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 1, 2005

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Compliance and Other Matters

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2004 and 2003, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated April 1, 2005. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

The management of the Board is responsible for complying with laws, regulations, and contracts applicable to the Board. As part of obtaining reasonable assurance about whether the Board's 2004 financial statements are free of material misstatement, we performed tests of the Board's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the Board. However, providing an opinion on compliance with laws, regulations, and contracts was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph of this report disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards*.

This report is intended solely for the information and use of the members of the Board and its management, the Office of the Inspector General, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 1, 2005

Federal Reserve Banks Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent auditors, for the years ended December 31, 2004 and 2003.

PRICEWATERHOUSECOOPERS

REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Banks:

We have audited the accompanying combined statements of condition of the Federal Reserve Banks (the "Reserve Banks") as of December 31, 2004 and 2003, and the related combined statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These combined financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 3, these combined financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the *Financial Accounting Manual for Federal Reserve Banks* and constitute a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 2004 and 2003, and the combined results of their operations for the years then ended, on the basis of accounting described in Note 3.

April 4, 2005
Washington, D.C.

PricewaterhouseCoopers LLP

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 2004 and 2003

(in millions)

Assets	2004	2003
Gold certificates	$ 11,041	$ 11,039
Special drawing rights certificates	2,200	2,200
Coin	728	722
Items in process of collection	6,233	7,793
Loans to depository institutions	43	62
Securities purchased under agreements to resell	33,000	43,750
U.S. government securities, net	725,584	675,569
Investments denominated in foreign currencies	21,368	19,868
Accrued interest receivable	5,104	5,064
Bank premises and equipment, net	2,216	2,117
Other assets	3,350	3,303
Total assets	$810,867	$771,487
Liabilities and Capital		
Liabilities		
Federal Reserve notes outstanding, net	$719,437	$689,757
Securities sold under agreements to repurchase	30,783	25,652
Deposits		
Depository institutions	24,043	23,058
U.S. Treasury, general account	5,912	5,723
Other deposits	332	394
Deferred credit items	5,306	7,582
Interest on Federal Reserve notes due U.S. Treasury	329	428
Accrued benefit costs	891	956
Other liabilities	290	243
Total liabilities	787,323	753,793
Capital		
Capital paid-in	11,914	8,847
Surplus	11,630	8,847
Total capital	23,544	17,694
Total liabilities and capital	$810,867	$771,487

The accompanying notes are an integral part of these combined financial statements.

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME
for the years ended December 31, 2004 and 2003

(in millions)

	2004	2003
Interest income		
Interest on U.S. government securities	$22,344	$22,597
Interest on investments denominated in foreign currencies	269	260
Interest on loans to depository institutions	3	1
Total interest income	22,616	22,858
Interest expense		
Interest expense on securities sold under agreements to repurchase	290	215
Net interest income	22,326	22,643
Other operating income		
Income from services	866	887
Reimbursable services to government agencies	370	328
Foreign currency gains, net	1,217	2,695
Other income	89	79
Total other operating income	2,542	3,989
Operating expenses		
Salaries and other benefits	1,604	1,819
Occupancy expense	222	213
Equipment expense	245	257
Assessments by Board of Governors	776	805
Other expenses	578	532
Total operating expenses	3,425	3,626
Net income prior to distribution	$21,443	$23,006
Distribution of net income		
Dividends paid to member banks	$ 582	$ 518
Transferred to surplus	2,783	467
Payments to U.S. Treasury as interest on Federal Reserve notes	18,078	22,021
Total distribution	$21,443	$23,006

The accompanying notes are an integral part of these combined financial statements.

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 2004 and 2003

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 2003 (167 million shares)	$ 8,380	$ 8,380	$16,760
Transferred to surplus	. . .	467	467
Net change in capital stock issued (9 million shares)	467	. . .	467
Balance at December 31, 2003 (176 million shares)	$ 8,847	$ 8,847	$17,694
Transferred to surplus	. . .	2,783	2,783
Net change in capital stock issued (61 million shares)	3,067	. . .	3,067
Balance at December 31, 2004 (238 million shares)	$11,914	$11,630	$23,544

The accompanying notes are an integral part of these combined financial statements.

Notes to the Combined Financial Statements of the Federal Reserve Banks

(1) Structure

The twelve Federal Reserve Banks (Reserve Banks) are part of the Federal Reserve System (System) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act) which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Open Market Committee (FOMC) and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (FRBNY) and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Although the Reserve Banks are chartered as independent organizations overseen by the Board of Governors, the Reserve Banks work jointly to carry out their statutory responsibilities. The majority of the assets, liabilities, and income of the Reserve Banks is derived from central bank activities and responsibilities with regard to monetary policy and currency. For this reason, the accompanying combined set of financial statements for the twelve independent Reserve Banks is prepared with adjustments to eliminate interdistrict accounts and transactions.

Board of Directors

The Reserve Banks serve twelve Federal Reserve Districts nationwide. In accordance with the Federal Reserve Act, supervision and control of each Reserve Bank is exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

(2) Operations and Services

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse (ACH) operations and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government’s bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The Board of Governors’ operating costs are funded through assessments on the Reserve Banks.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

In performing fiscal agency functions for the U.S. Treasury, seven Reserve Banks provide U.S. securities direct purchase and savings bond processing services. In March 2004, the U.S. Treasury provided an implementation plan for consolidating the provision of these services at the Cleveland and Minneapolis Reserve Banks. The costs for the associated restructuring for the affected Banks have been included in footnote 10.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY is also authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange (“F/X”) and securities contracts in, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. In addition, FRBNY is authorized to maintain reciprocal currency arrangements (“F/X swaps”) with various central banks, and “warehouse” foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (“ESF”) through the Reserve Banks.

(3) SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation’s central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (*Financial Accounting Manual*), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the *Financial Accounting Manual*.

These combined financial statements have been prepared in accordance with the *Financial Accounting Manual*. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles in the United States of America (GAAP). The primary difference is the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included, because the liquidity and cash position of the Reserve Banks are not of primary concern to users of these combined financial statements. Other information regarding the Reserve Banks’ activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. A Statement of Cash Flows, therefore, would not provide any additional useful information. There are no other significant differences between the policies outlined in the *Financial Accounting Manual* and GAAP.

The preparation of the combined financial statements in conformity with the *Financial Accounting Manual* requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the combined financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

(A) *Gold Certificates*

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury’s account is charged and the Reserve Banks’ gold certificate account is lowered. The value of gold for purposes of backing the gold certificates is set by law at \$42 2/9 a fine troy ounce.

(B) *Special Drawing Rights Certificates*

Special drawing rights (SDRs) are issued by the International Monetary Fund (Fund) to its members in proportion to each member’s quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate account is increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. There were no SDR transactions in 2004 or 2003.

(C) *Loans to Depository Institutions*

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of each Reserve Bank, subject to review by the Board of Governors.

(D) *U.S. Government Securities and Investments Denominated in Foreign Currencies*

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account (SOMA). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

In addition to sales of securities under agreements to repurchase, the FRBNY may engage in tri-party purchases of securities under agreements to resell (tri-party agreements). Tri-party agreements are conducted with two custodial banks that manage the clearing and settlement of collateral. Acceptable collateral under tri-party agreements primarily includes U.S. government securities, pass-through mortgage securities of Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association, STRIP securities of the U.S. government and ‘‘stripped’’ securities of other government agencies. The tri-party agreements are accounted for as financing transactions with the associated interest income accrued over the life of the agreements.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the FRBNY on a daily basis, with additional collateral obtained as necessary. The securities lent are accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The Bank will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts that contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement, and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that may result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Securities sold under agreements to repurchase are accounted for as secured borrowing transactions with the associated interest expense recognized over the life of the transaction. Such transactions are settled by FRBNY. Interest income is accrued on a straight-line basis. Income earned on securities lending transactions is reported as a component of ‘‘Other income.’’ Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as ‘‘Foreign currency gains (losses), net.’’

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Activity related to U.S. government securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, excluding those held under an F/X swap arrangement, and deposit accounts of foreign central banks and governments above core balances are allocated to each Reserve Bank. U.S. government securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

In 2003, additional interest income of $61 million, representing one day's interest on the SOMA portfolio, was accrued to reflect a change in interest accrual calculations. The effect of this change was not material; therefore, it was included in 2003 interest income.

(E) *Bank Premises, Equipment, and Software*

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

(F) *Federal Reserve Notes*

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In 2003, the Federal Reserve Act was amended to expand the assets eligible to be pledged as collateral security to include all Federal Reserve Bank assets. Prior to the amendment, only gold certificates, special drawing rights certificates, U.S. government securities, securities purchased under agreements to resell, loans to depository institutions, and investments denominated in foreign currencies could be pledged as collateral. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered and securities purchased under agreements to resell, which are valued at the contract amount. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes outstanding reduced by the Reserve Banks' currency holdings of $128,933 million and $110,176 million at December 31, 2004 and 2003, respectively.

At December 31, 2004, all Federal Reserve notes outstanding were fully collateralized. All gold certificates, all special drawing rights certificates, and $706,196 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2004, no loans or investments denominated in foreign currencies were pledged as collateral.

(G) *Capital Paid-In*

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of the Reserve Bank's stock must be adjusted. Member banks are state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

The Financial Accounting Standards Board (FASB) has deferred the implementation date for SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" for the Banks. When applicable, the Banks will determine the impact and provide the appropriate disclosures.

(H) *Surplus*

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital.

Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses or an increase in capital paid-in, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in. Weekly payments to the U.S. Treasury may vary significantly.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to U.S. Treasury in the following year. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes."

(I) *Income and Costs Related to Treasury Services*

Reserve Banks are required by the Federal Reserve Act to serve as fiscal agents and depositories of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

(J) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. Real property taxes were $33 million for each of the years ended December 31, 2004 and 2003, and are reported as a component of "Occupancy expense."

(K) *Restructuring Charges*

In 2003, the System started the restructuring of several operations, primarily check, cash, and Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations. These restructuring activities continued in 2004.

Footnote 10 describes the restructuring and provides information about the Banks' costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY.

(4) U.S. GOVERNMENT SECURITIES

Securities bought outright are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31 that were bought outright, were as follows (in millions):

	2004	2003
Par value		
U.S. government		
Bills	$262,970	$244,833
Notes	360,832	323,361
Bonds	94,017	98,471
Total par value	717,819	666,665
Unamortized premiums	9,405	9,797
Unaccreted discounts	(1,640)	(893)
Total	$725,584	$675,569

The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase, which were held in the SOMA at December 31, 2004, was as follows (in millions):

Maturities of securities held	U.S. government securities (Par)	Securities purchased under agreements to resell (Contract amount)	Securities sold under agreements to repurchase (Contract amount)
Within 15 days	$ 30,647	$33,000	$30,783
16 days to 90 days	178,355	. . .	. . .
91 days to 1 year	170,411	. . .	. . .
Over 1 year to 5 years	208,269	. . .	. . .
Over 5 years to 10 years	54,372	. . .	. . .
Over 10 years	75,765	. . .	. . .
Total	$717,819	$33,000	$30,783

At December 31, 2004 and 2003, U.S. government securities, net with par values of $6,609 million and $4,426 million, respectively, were loaned from the SOMA.

At December 31, 2004 and 2003, securities sold under agreements to repurchase with a contract amount of $30,783 million and $25,652 million, respectively, were outstanding. At December 31, 2004 and 2003, securities sold under agreements to repurchase with a par value of $30,808 million and $25,658 million, respectively, were outstanding.

(5) INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements, and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Total investments denominated in foreign currencies, valued at current foreign currency market exchange rates at December 31, were as follows (in millions):

	2004	2003
European Union euro		
Foreign currency deposits	$ 6,063	$ 6,870
Securities purchased under agreements to resell	2,142	2,057
Government debt instruments	3,840	2,033
Japanese yen		
Foreign currency deposits	1,540	1,475
Government debt instruments	7,660	7,341
Accrued interest	123	92
Total	$21,368	$19,868

The maturity distribution of investments denominated in foreign currencies at December 31, 2004, was as follows (in millions):

Maturities of investments denominated in foreign currencies	European Union euro	Japanese yen	Total
Within 1 year	$ 8,978	$9,199	$18,177
Over 1 year to 5 years	3,006	. . .	3,006
Over 5 years to 10 years	185	. . .	185
Over 10 years	. . .	. . .	. . .
Total	$12,169	$9,199	$21,368

At December 31, 2004 and 2003, there were no outstanding F/X swaps or material open foreign exchange contracts.

At December 31, 2004 and 2003, the warehousing facility was $5,000 million, with no balance outstanding.

(6) Bank Premises, Equipment, and Software

A summary of bank premises and equipment at December 31 is as follows (in millions):

	Maximum useful life (in years)	2004	2003
Bank premises and equipment			
Land	N/A	$ 274	$ 244
Buildings	50	1,631	1,559
Building machinery and equipment	20	373	364
Construction in progress	N/A	202	96
Furniture and equipment	10	1,200	1,334
Subtotal		$3,680	$3,597
Accumulated depreciation		(1,464)	(1,480)
Bank premises and equipment, net		$2,216	$2,117
Depreciation expense, for the years ended		$ 179	$ 184

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	2004	2003
Bank premises and equipment	$11	$ 9
Accumulated depreciation	(6)	(6)
Capitalized leases, net	$ 5	$ 3

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 12 years. Rental income from such leases totaled $21 million and $20 million for the years ended December 31, 2004 and 2003, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2004, were (in millions):

2005	$ 20
2006	17
2007	12
2008	11
2009	10
Thereafter	43
Total	$113

The Reserve Banks have capitalized software assets, net of amortization, of $203 million and $164 million at December 31, 2004 and 2003, respectively. Amortization expense was $56 million and $54 million for the years ended December 31, 2004 and 2003, respectively.

Several Reserve Banks impaired assets as a result of the System's restructuring plans, as discussed in footnote 10. Impaired assets include software, buildings, leasehold improvements, furniture, and equipment. Asset impairment losses related to the restructuring and check processing standardization of $21 million and $11 million for the years ended December 31, 2004 and 2003, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

Three Reserve Banks are constructing new buildings, one to replace the head office and two to replace branch offices. At December 31, 2004, the contractual obligation for these projects has been recognized or is reported as a commitment in footnote 7 below.

(7) Commitments and Contingencies

At December 31, 2004, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 to 20 years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $70 million and $71 million for the years ended December 31, 2004 and 2003, respectively. Certain of the Reserve Banks' leases have options to renew.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Future minimum rental payments under noncancelable operating and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2004, were (in millions):

	Operating	Capital
2005	$ 10.2	$ 1.6
2006	8.9	1.5
2007	8.0	.6
2008	7.1	.2
2009	7.2	.1
Thereafter	114.3	. . .
	$155.7	$ 4.0
Amount representing Interest		(.3)
Present value of minimum lease payments		$ 3.7

At December 31, 2004, the Reserve Banks had contractual commitments through the year 2011 totaling $307 million, $58 million of which has been recognized. Purchases of $117 million and $76 million were made against these commitments during 2004 and 2003, respectively. These commitments are for goods and services for the maintenance of currency machines, check-processing-related services, and check transportation services, and have variable and fixed components. The variable portion of the commitment is for additional services above fixed contractual service limits. The fixed payments for the next five years under these commitments are (in millions):

	Fixed commitment
2005	$89.5
2006	66.2
2007	23.9
2008	.7
2009	.7

The Reserve Banks are involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Reserve Banks.

(8) RETIREMENT AND THRIFT PLANS

Retirement Plans

The Reserve Banks currently offer two defined benefit retirement plans to their employees, based on length of service and level of compensation. Substantially all of the Reserve Banks', Board of Governors', and the Plan Administrative Office's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEP). In addition, certain Bank officers participate in a Supplemental Employee Retirement Plan (SERP).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. Certain Board employees not covered by the Social Security Act also contribute to the plan. No separate accounting is maintained of assets contributed by the participating employers. FRBNY acts as a sponsor of the Plan for the System and costs associated with the Plan are not redistributed to other participating employers. The prepaid pension cost includes amounts related to the participating employees of all employers who participate in the plans.

Following is a reconciliation of the beginning and ending balances of the System Plan benefit obligation (in millions):

	2004	2003
Estimated actuarial present value of projected benefit obligation at January 1	$3,930	$3,523
Service cost—benefits earned during the period	116	109
Interest cost on projected benefit obligation	245	232
Actuarial loss	457	192
Special termination loss	20	67
Contributions by plan participants	3	4
Benefits paid	(247)	(197)
Plan amendments	. . .	. . .
Estimated actuarial present value of projected benefit obligation at December 31	$4,524	$3,930

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Following is a reconciliation of the beginning and ending balances of the System Plan assets, the funded status, and the prepaid pension benefit costs (in millions):

	2004	2003
Estimated fair value of plan assets at January 1	$5,703	$4,997
Actual return on plan assets	428	899
Contributions by plan participants	3	4
Employer contributions	. . .	. . .
Benefits paid	(247)	(197)
Estimated fair value of plan assets at December 31	$5,887	$5,703
Funded status	$1,362	$1,774
Unrecognized prior service cost	173	197
Unrecognized net actuarial loss	1,182	710
Prepaid pension benefit costs	$2,717	$2,681

Prepaid pension benefit costs are reported as a component of "Other assets."

The accumulated benefit obligation for the defined benefit pension plan was $3,894 million and $3,456 million at December 31, 2004 and 2003, respectively.

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan as of December 31 are as follows:

	2004	2003
Discount rate	5.75%	6.25%
Rate of compensation increase	4.25%	4.00%

The weighted-average assumptions used in developing net periodic benefit cost for the System Plan for the years ending December 31 are as follows:

	2004	2003
Discount rate	6.25%	6.75%
Expected asset return	8.25%	8.50%
Rate of compensation increase	4.00%	4.25%

The long-term rate of return on assets was based on a combination of methodologies including the System Plan's historical returns, surveys of other plans' expected rates of return, building a projected return for equities and fixed income investments based on real interest rates, inflation expectations and equity risk premiums and finally, surveys of expected returns in equity and fixed income markets.

The components of net periodic pension benefit (credit) cost for the System Plan as of December 31 are shown below (in millions):

	2004	2003
Service cost—benefits earned during the period	$ 116	$ 109
Interest cost on projected benefit obligation	245	232
Amortization of prior service cost	24	26
Recognized net loss	20	42
Expected return on plan assets	(462)	(418)
Net periodic pension benefit credit	(57)	(9)
Special termination benefits	20	67
Net periodic pension benefit (credit) cost	$ (37)	$ 58

The recognition of special termination benefits is the result of enhanced retirement benefits provided to 384 System employees in conjunction with the restructuring disclosed in footnote 10. Net periodic pension benefit (credit) cost is reported as a component of "Salaries and other benefits."

The expected benefit payments for the next ten years (in millions) are:

	Expected benefit payments
2005	$ 206
2006	219
2007	224
2008	228
2009	235
2010–2014	1,406
Total	$2,518

The Federal Reserve System's pension plan weighted-average asset allocations at December 31, by asset category, are as follows:

	2004	2003
Equities	67.5%	61.9%
Fixed income	30.0%	34.8%
Cash	2.5%	3.3%
Total	100.0%	100.0%

The System's Committee on Investment Performance (CIP) contracts with investment managers who are responsible for implementing the System Plan's investment policies. The managers' performance is measured against a trailing 36-month-benchmark of 60 percent of a market value weighted index of predominantly large capitalization stocks trading on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation National Market System and 40 percent of a broadly diversified investment-grade fixed income index (rebalanced monthly). The managers invest Plan funds within CIP-established guidelines for investment in equities and fixed income instruments. Equity investments can range between 40 percent and 80 percent of the portfolio. Investments, however, cannot be concentrated in particular industries and equity security holdings of any one company are limited. Fixed income securities must be investment grade and the effective duration of the fixed income portfolio must remain within a range of 67 percent and 150 percent of a broadly diversified investment-grade fixed income index. CIP guidelines prohibit margin, short sale, foreign exchange, and commodities trading as well as investment in bank, bank holding company, savings and loan, and government securities dealer's stocks. In addition, investments in non-dollar denominated securities are prohibited; however, a small portion of the portfolio can be invested in American Depositary Receipts/Shares and foreign-issued dollar denominated fixed income securities.

The Federal Reserve System does not expect to make a cash contribution to the Retirement Plan during 2005.

The Reserve Banks' projected benefit obligations and net pension costs for the BEP and the SERP at December 31, 2004 and 2003, and for the years then ended, are not material.

Thrift Plan

Employees of the Reserve Banks may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Reserve Banks' Thrift Plan contributions totaled $63 million for the year ended December 31, 2004, and $64 million for the year ended December 31, 2003, and are reported as a component of "Salaries and other benefits."

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

In addition to the Reserve Banks' retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement.

The Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

Following is a reconciliation of the beginning and ending balances of the benefit obligation (in millions):

	2004	2003
Accumulated postretirement benefit obligation at January 1	$942	$742
Service cost—benefits earned during the period	19	18
Interest cost of accumulated benefit obligation	52	50
Actuarial loss	10	157
Curtailment (gain)/loss	(2)	7
Special termination loss	1	2
Contributions by plan participants	9	6
Benefits paid	(50)	(40)
Plan amendments	(112)	. . .
Accumulated postretirement benefit obligation at December 31	$869	$942

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 6.25 percent, respectively.

Following is a reconciliation of the beginning and ending balances of the plan assets, the unfunded postretirement benefit obligation and the accrued postretirement benefit costs (in millions):

	2004	2003
Fair value of plan assets at January 1	$ . . .	$ . . .
Contributions by the employer	42	34
Contributions by plan participants	8	6
Benefits paid	(50)	(40)
Fair value of plan assets at December 31	$ . . .	$ . . .
Unfunded postretirement benefit obligation	$869	$942
Unrecognized net curtailment gain	5	2
Unrecognized prior service cost	128	122
Unrecognized net actuarial loss	(247)	(246)
Accrued postretirement benefit costs	$755	$820

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

For measurement purposes, the assumed health care cost trend rates at December 31 are as follows:

	2004	2003
Health care cost trend rate assumed for next year	9.00%	10.00%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	4.75%	5.00%
Year that the rate reaches the ultimate trend rate	2011	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2004 (in millions):

	One percentage point increase	One percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 10	$ (8)
Effect on accumulated postretirement benefit obligation	105	(86)

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The following is a summary of the components of net periodic postretirement benefit costs for the years ended December 31 (in millions):

	2004	2003
Service cost—benefits earned during the period	$ 19	$18
Interest cost of accumulated benefit obligation	52	50
Amortization of prior service cost	(17)	(15)
Recognized net actuarial loss	8	4
Total periodic expense	62	57
Curtailment (gain)/loss	(86)	5
Special termination loss	1	2
Net periodic postretirement benefit (credit)/costs	$(23)	$64

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 6.25 percent and 6.75 percent, respectively.

Net periodic postretirement benefit costs are reported as a component of "Salaries and other benefits."

A plan amendment that modified the credited service period eligibility requirements created curtailment gains. The recognition of special termination losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) was enacted in December 2003. The Act established a prescription drug benefit under Medicare (Medicare Part D) and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. Following the guidance of the Financial Accounting Standards Board, the Bank elected to defer recognition of the financial effects of the Act until further guidance was issued in May 2004.

Benefits provided to certain participants are at least actuarially equivalent to Medicare Part D. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit costs.

Following is a summary of the effects of the expected subsidy (in millions):

	2004
Decrease in the accumulated postretirement benefit obligation	$120
Decrease in the net periodic postretirement benefit costs	16

Expected benefit payments:

	Without subsidy	With subsidy
2005	$ 45	$ 45
2006	47	43
2007	49	44
2008	51	46
2009	52	47
2010–2014	288	257
Total	$532	$482

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2004, measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. For 2004, the Banks changed their practices for estimating postemployment costs and used a 5.25 percent discount rate and the same health care trend rates as were used for projecting postretirement costs. Costs for 2003, however, were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Banks at December 31, 2004 and 2003, were $128 million and $130 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2004 and 2003 operating expenses were $17 million and $26 million, respectively.

10. BUSINESS RESTRUCTURING CHARGES

In 2003, several Banks announced consolidation and restructuring plans to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions. In 2004, additional consolidation and restructuring initiatives were announced in the check and fiscal services operations. These actions resulted in the following business restructuring charges:

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Major categories of expense (in millions):

	Total estimated costs
Employee separation	$61
Contract termination	1
Other	1
Total	$63

	Accrued liability 12/31/03	Total charges	Total paid	Accrued liability 12/31/04
Employee separation	$29	$25	$(26)	$28
Contract termination	1	. . .	. . .	1
Other	. . .	. . .	. . .	. . .
Total	$30	$25	$(26)	$29

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 1,290, including some of the 1,483 staff reductions related to restructuring that was announced in 2003, and have not been paid out. These costs are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

Restructing costs associated with the write-downs of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2005 and 2006.

The Reserve Banks anticipate substantially completing their announced restructuring plans by March 2006.

Office of Inspector General Activities

The Board's Office of Inspector General (OIG) functions in accordance with the Inspector General Act of 1978, as amended. In addition to retaining an independent auditor each year to audit the Board's financial statements, the OIG plans and conducts audits and investigations of the Board's programs and operations and its delegated functions at the Federal Reserve Banks. The OIG also reviews existing and proposed legislation and regulations for economy and efficiency. It recommends policies, and it supervises and conducts activities that promote economy and efficiency and that prevent and detect waste, fraud, and abuse in Board and Board-delegated programs and operations, as well as in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2004, the OIG completed ten audits, reviews, and other assessments and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. The OIG also closed nine investigations and performed numerous legislative and regulatory reviews.

Audits, Reviews, and Assessments Completed during 2004

Report title	Month issued
Audit of the FFIEC's Financial Statements (Year Ended December 31, 2003)	February
Review of Internal Control Assessments Performed during Community Bank Examinations	March
Evaluation of Key Emergency Preparedness and Security Enhancements	March
Audit of the Board's Financial Statements (Year Ended December 31, 2003)	April
Audit of the Board's Outsourcing Operations	April
Evaluation of the Fine Arts Program	April
Evaluation of the Administrative Controls Over an Outsourced Contract	June
Review of the Oversight Function of the Division of Reserve Bank Operations and Payment Systems	August
Audit of the Board's Information Security Program	September
Audit of the Board's Automated Travel System	November

Government Accountability Office Reviews

Under the Federal Banking Agency Audit Act (Public Law 95–320), most Federal Reserve System operations are under the purview of the Government Accountability Office (GAO). In 2004, the GAO completed six reports on selected aspects of Federal Reserve operations. In addition, five projects concerning the Federal Reserve were in various stages of completion at year-end. The Federal Reserve also provided information to the GAO during the year in relation to numerous other GAO investigations.

The completed reports are available directly from the GAO.

Reports Completed during 2004

Report title	Report number	Month issued (2004)
Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending	GAO-04-280	January
Federal Reserve Banks: Areas for Improvement in Computer Controls	GAO-04-336R	March
Coins and Currency: How the Costs and Earnings Associated with Producing Coins and Currency Are Budgeted and Accounted For	GAO-04-283	April
Regulatory Information Sharing: Better Information Sharing among Financial Services Regulators Could Improve Protections for Consumers	GAO-04-882R	June
Foreign Regimes' Assets: The United States Faces Challenges in Recovering Assets, but Has Mechanisms that Could Guide Future Efforts	GAO-04-1006	September
Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure	GAO-05-61	October

Projects Active at Year-End 2004

Subject of project	Month initiated (2004)
USA Patriot Act implementation	January
Bank Secrecy Act examinations	January
Industrial loan corporations	May
Information security at financial organizations	November
Consumer impact on remittance transfer system	December